STATEMENT OF
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SOUTHEAST/CARIBBEAN DISTRICT
U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
Tuesday March 23, 1999
BEFORE THE GOVERNMENT REFORM COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

PRELIMINARY RESULTS OF THE AUDIT OF HUD'S PROPERTY MANAGEMENT AND DISPOSITION ACTIVITIES

Chairman Burton, Ranking Member Waxman, and other members of the Government Reform Committee, I appreciate the opportunity to appear before you today to discuss the status of HUD's Single Family Property Management and Disposition Activities. Your interest is in the preliminary results of our ongoing nationwide audit and HUD's ability – while in transition to the new management and marketing service contracts – to monitor and oversee current property disposition activities. You also requested current statistical data on various aspects of HUD's operations.

Late last year, my staff began an audit of HUD's management of its single family property inventory, referred to in HUD as Real Estate Owned (REO). At that time, HUD was well into its HUD 2020 Management Reform Plan. HUD had reduced its single family staff by over 50 percent and its plans to privatize the management and marketing of its properties had not materialized. Our audit objective was to see what impact HUD 2020 organizational and staffing changes were having on HUD's mission and performance goals. We were concerned that the poor property conditions and management inefficiencies reported by the General Accounting Office (GAO) in March 1998 might still exist. We were also concerned that circumstances created by staff reductions increased the risk of program fraud.

Before I start, let me reiterate that we have not completed our audit, especially with respect to the future of HUD's REO operations. As of March 29, 1999, the current REO operation will dramatically change. It will be replaced by 16 management and marketing contracts nationwide. These contractors will handle nearly every aspect of HUD's multi-billion dollar REO program. The 5 year estimated cost for contractors to manage this portfolio is about $900 million. What I will discuss today is our preliminary assessment of HUD's REO operations from January 1, 1997 to date. Our preliminary results show that conditions have not changed since the GAO review. In fact, conditions today may be worse.

Today, I cannot speak about the new contracts or predict their success. However, our final audit report will address these issues.

Background on Real Estate Asset Management and HUD 2020 Plan

When borrowers default on single family mortgages insured by HUD, the Department encourages lenders to work with the borrowers to bring their mortgage payments up to date. If that is not possible, the homes may be sold to third parties, voluntarily conveyed to the lender, or surrendered to the lenders through foreclosure. When lenders obtain these properties, they generally convey them to HUD in exchange for payment of insurance claims. HUD also takes possession of abandoned properties secured by HUD-held mortgages and protects and maintains these properties, referred to as "custodial" properties, pending acquisition of title.

In March 1997, HUD issued its proposed 2020 Field Consolidation Plan for Single Family Housing. The plan was conceptualized in 1993 and 1994 to consolidate field functions into equal homeownership centers fully functioning for processing and underwriting, asset management, marketing and outreach, and quality assurance. The plan stated that these Homeownership Centers would be fully operational by October 1998, including outsourcing REO activities and selling nearly all assigned notes. It was never intended that Homeownership Centers would handle the full range of loan management and property management and disposition functions they are currently handling. HUD anticipated that it would need about 70 field employees for REO management and oversight by the year 2000.

HUD's consolidation of REO functions has not progressed as planned. There are currently about 300 REO field staff working under the following structure:

- Four Homeownership Centers located in Philadelphia, Atlanta, Denver, and Santa Ana
- 73 HUD field offices offering varying degrees of staff and support
- Over 300 real estate asset management (REAM) contractors responsible for securing, maintaining and preparing properties for sale
- Three pilot Management and Marketing contracts (all to Golden Feather Realty, Inc.)
- Four emergency Management and Marketing contracts in Birmingham, Jacksonville, Coral Gables, and Chicago

- Property inspection contracts to facilitate HUD’s monitoring needs

Our audit has focused on performance of HUD and its contractors, record keeping and reporting, and condition of HUD held properties. We have visited the Homeownership Centers in Atlanta, Denver and Santa Ana. We have also performed work in HUD’s Chicago, New Orleans, and Coral Gables field offices. We plan to visit the Philadelphia Homeownership Center and return to Santa Ana. To date, we have inspected 37 homes, reviewed over 1,600 inspection reports, and evaluated 8 asset management contractors.

Preliminary results indicate overall conditions have not improved since GAO’s report in March 1998. HUD’s own statistics indicate, and our audit confirms, that some areas have worsened. Although results are preliminary, they mirror the recent Independent Auditor’s report by KPMG issued on March 12, 1999. KPMG performed an audit of FHA’s Financial Statements for Fiscal Year 1998.

REO Mission

HUD’s REO mission is to reduce the inventory of acquired properties in a manner that:

- expands homeownership
- strengthens neighborhoods and communities
- ensures maximum return to the mortgage insurance fund.

...to reduce the inventory of acquired properties

Chart 1 shows HUD’s inventory over the last 2 ½ years. Despite HUD’s intentions, the property inventory has increased 70 percent from about 24,700 properties on October 1, 1996, to over 42,000 on February 28, 1999. An unusual increase in defaults and claims could be a contributing factor. If so, HUD was unprepared to handle it.

Chart 1

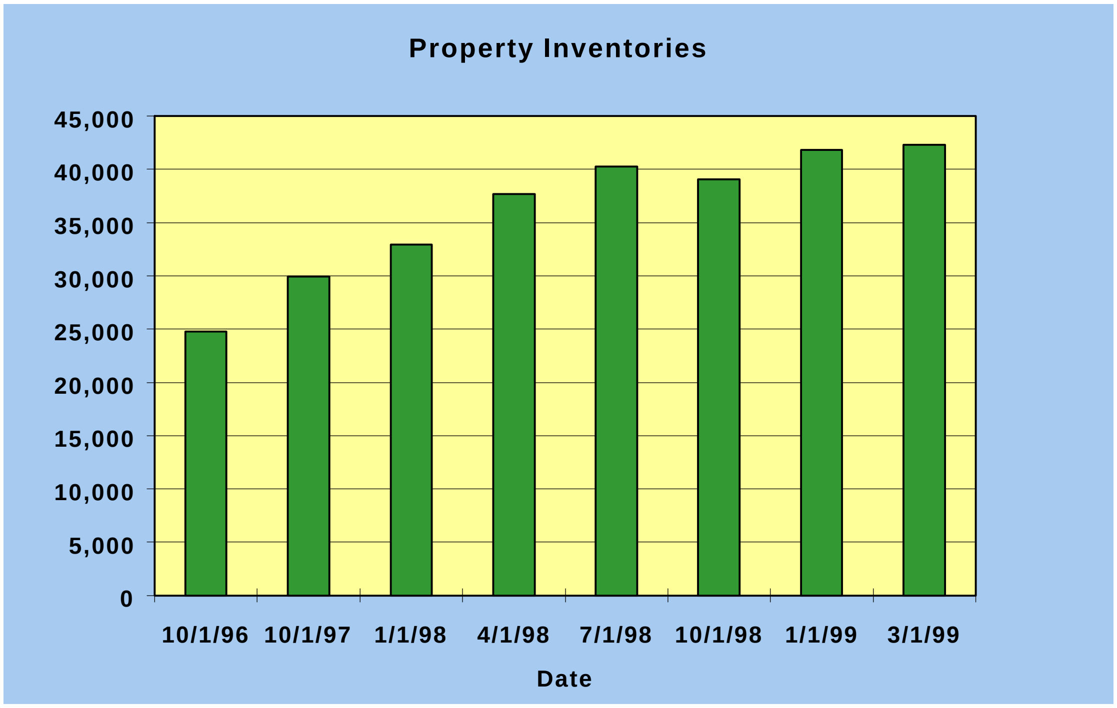
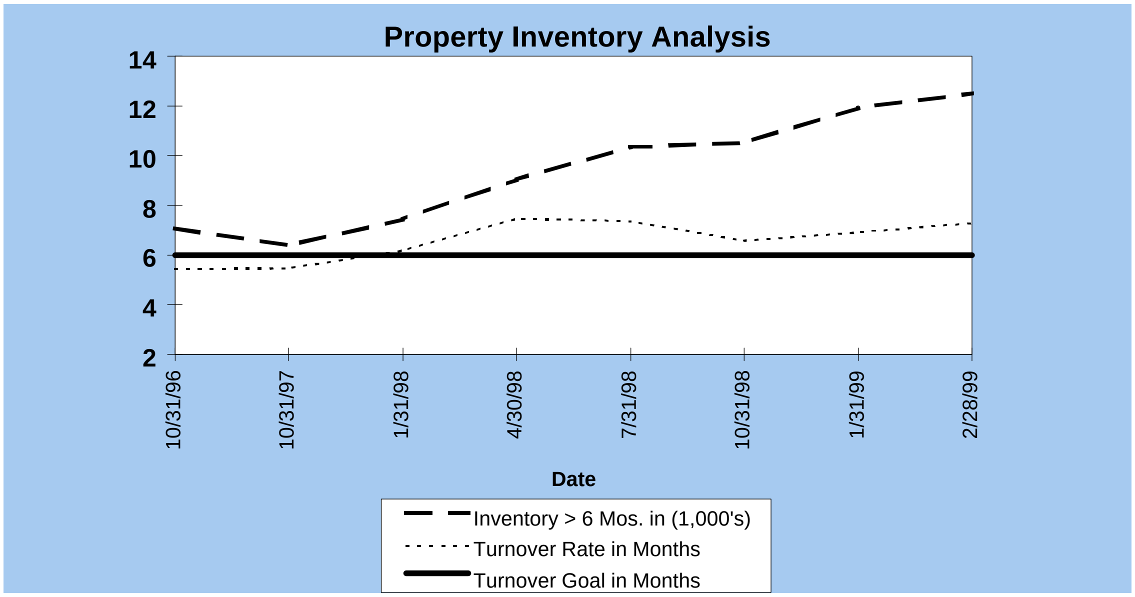


Chart 2 shows the turnover of properties in HUD's inventory. HUD strives to sell properties within 6 months after acquisition. HUD monitors its success by determining its property turnover rate and determining the number of properties that have been in inventory over 6 months. HUD's turnover is increasing and its inventory is aging. During the same period from October 1996 through February 1999, the turnover rate has increased 32 percent from over 5 months to over 7 months. Similarly, the inventory of properties over 6 months old has increased 76 percent from 7,100 properties to 12,500 properties.

Chart 2



...expands homeownership

HUD could do a better job in meeting its mission of expanding homeownership through the REO program. The percentage of property sales to homeowners has declined from 73 percent in October 1996 to 57 percent in February 1999. In contrast, sales to investors increased from 21 percent to 33 percent for the same period.

...strengthens neighborhoods and communities

We performed 37 property inspections which revealed extensive non-compliance by the contractors HUD hired to manage these properties.

Debris outside or inside - 53 percent
Property not secure - 27 percent
Defective paint outside or inside - 50 percent
Water damage - 23 percent
Vandalism - 31 percent
No HUD sign - 61 percent
No regular inspections - 39 percent

We identified one or more deficiencies at all 37 properties we inspected. Our review of 1614[1] inspections performed by contract inspectors within the last year noted many deficiencies:

Debris outside - 14 percent
Debris inside - 22 percent
Property not secure - 15 percent
Defective paint outside or inside - 11 percent
Water damage - 7 percent
Vandalism - 19 percent
No HUD sign - 7 percent
No regular inspections - 18 percent

We have photographs of several properties in HUD's current inventory. As requested, we have supplied these photographs separately for the record. Our inspections and review of inspection reports confirm that these examples are not isolated cases:

This property located in Rockford, Illinois (Photo 1) was acquired in May 1998. It was appraised for $18,000 and currently lists for $17,100. HUD's costs to date total about $28,000 including $25,800 paid to the mortgagee for its insurance claim, $2,300 paid to the maintenance contractor, and $500 for miscellaneous expenses. This picture was taken in December 1998 by a contract inspector. In addition to the damage shown here, he reported the kitchen and bathroom were filthy. The report said the maintenance contractor had made regular visits.

The next property (photo 2) shows the front of a property in Miami acquired in November 1997. We took this picture a week ago.

The back of the property (photo 3) is overgrown and littered with debris. A HUD inspection conducted in January 1999 showed that there was debris inside and out and significant vandalism. The inspector reported that the maintenance contractor did not make regular inspections. It was appraised in February 1999 at $34,200, as is, and is listed for sale at that price. HUD's cost to date is $79,690.

Next is property we inspected in Los Angeles, California in September 1998 (photo 4). Our inspection showed neglect by the maintenance contractor including debris outside.

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[1] Our review of 1614 inspection reports was not selected statistically and therefore, may not be representative of HUD's property inventory as a whole.

This is the same property on March 13, 1999 (photo 5). The property continues to be neglected; the lawn has not been mowed for some time.

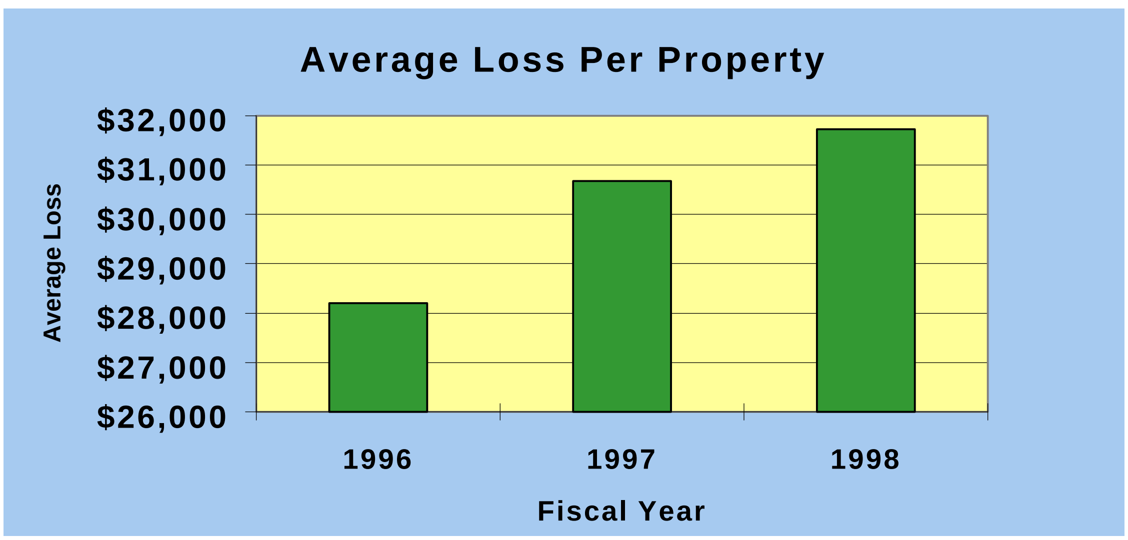
This is a view of a property (photo 6) in Los Angeles, California taken in September 1998. The roof is obviously leaking, and the REAM was under contract to fix it.

We took a picture (photo 7) of the ceiling again on March 13, 1999. The roof was not repaired and the ceiling has fallen in; now a much more expensive repair.

...ensures a maximum return to the mortgage insurance fund.

HUD did not meet its mission of ensuring a maximum return to the mortgage insurance fund. Chart 3 shows that HUD's average loss per property, based on acquisition costs (income from sales less all related expenses), increased from $28,202 in fiscal year 1996 to $31,728 in fiscal year 1998. As a result, the loss to the mortgage insurance fund increased from $1.5 billion in fiscal year 1996 to slightly over $2 billion in fiscal year 1998.

Chart 3



Staff Monitoring and Oversight

It is our opinion that HUD field staff have done all they could do to keep up. Last October, we observed a Santa Ana staff that were barely keeping their heads above water. There was a staff of 18, with plans to be fully staffed at only 22, to manage a portfolio of about 16,000 properties. They were given a yearly sales goal which computed to 1,145 sales per employee. Their workload per staff was twice that of other Homeownership Centers. The former REO Director who left after 31 years of service in HUD told us the staff reductions were having major negative impacts on REO's mission. He considered the situation unmanageable. Since our visit, Santa Ana has gotten some relief. We plan to visit them again.

Staff problems were so severe in Chicago, Birmingham, Jacksonville, and Coral Gables, that emergency Management and Marketing contracts were let for contractors to handle many of the normal field office staff duties. In Birmingham and Atlanta, REAM monitoring contractors were hired to perform property inspections. Workloads were shifted among offices because certain offices had no REO staff. Because of staff shortages, inexperienced staff, increased workload, limited travel funds, and ineffective compliance enforcement, HUD's monitoring has not been effective.

Timely reviews of property management contractors were not performed even when they were considered "high risk." For example:

> The Coral Gables Field Office reviewed a contractor on November 21, 1996, and rated it "low risk" meaning HUD should plan another review in 6 months. However, HUD did not review this REAM contractor again until June 16, 1998, 13 months later than required. This time, the contractor was rated "high risk." A high risk designation required HUD to perform monthly reviews. In this case, however, HUD did not visit the contractor again until December 1998, 5 months late. The contractor was again rated as high risk. As of last week, HUD had not been back to monitor the contractor. One of the properties in our photos were under contract with this company.
>
> The Coral Gables Field Office reviewed another REAM in October 1996 giving it a low risk rating. The next review was performed 21 months later in July 1998. This time, the REAM contractor was rated high risk. As of March 15, 1999, 9 months later, HUD had performed no other reviews of this contractor.

Affirmative enforcement actions, such as assessing monetary penalties or terminating contracts, were not taken even when deficient contractor performance was found. Let me focus briefly on this last point because it affects the future plans in the Department. Preliminary information indicates that HUD has not had an effective or swift enforcement procedure in place to deal with non-performing contractors. Effective enforcement becomes even more critical in HUD's future plans to contract out even more of its operations.

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We plan to complete our work and issue our audit report in July 1999. We will evaluate the adequacy of HUD's management controls in recently awarded Marketing and Management contracts, and HUD's newly published procedures to monitor contractors. We expect to focus recommendations on the adequacy of management controls to (1) track performance (2) see that mission goals are met, (3) enforce contract compliance, and (4) assess monetary penalties for contract non-compliance.